CREDIT COMMENTS

NORTH AMERICAN ELECTRIC UTILITIES FACE RESTRUCTURING

U.S. electric utilities are under increasing competitive pressures because of continued actions by market participants to break down monopolies that have traditionally protected them. In Canada, although substantially greater competition in electric power markets has not yet arrived, the same underlying trend is evident.

Mounting competition in the U.S. undoubtedly will translate into lower rates for most investor-owned and publicly owned electric utilities. Thus, financial margins and earnings likely will be impaired. As a result, ratings on electric utilities with potentially volatile profits, coverage protection, and customer bases are at risk.

Nonetheless, not all U.S. utilities will fare similarly in the changing and increasingly competitive market. Standard & Poor's believes that the country's investor-owned utilities (IOUs), which represent about 76% of total U.S. utility energy sales, will be impacted to a greater extent and more immediately than publicly owned systems. IOUs' nuclear plant investment, industrial customer concentration, and dividend payout pressures will lead to greater relative credit deterioration for this sector. This has already been borne out in the downgrades of over 40 IOUs, representing in excess of one-third of those rated, since October 1993, when Standard & Poor's adjusted its financial guidelines for electric utilities. However, some public power systems, particularly those with high fixed costs, large debt burdens, and uncompetitive rates will be negatively impacted by the movement toward deregulation.

Credit risk will begin intensifying over the next few years, as various levels of retail wheeling take hold. This creates a window during which utilities likely will move to position themselves for future competitive battles. Some IOUs and public power systems alike already are using this time to restructure rates, reduce otherwise high costs, and negotiate agreements with high load-factor customers. More than public power systems, investor-owned utilities are also looking at consolidating operations and paying off high-cost debt to enhance their operating postures. Utilities that employ some or all of these techniques can retain their credit quality. Others, which do little to stem high and rising costs, could see their business positions and credit quality deteriorate over the coming years.

U.S. INVESTOR-OWNED UTILITIES

The essence of the risk faced by investor-owned electric utilities is that competition is likely to mean lower prices. Over the next several years, Standard & Poor's believes that electricity prices will be under pressure because of several factors, including:

- Excess generating capacity,
- Improving generating technology,
- Aggressive pricing, and
- Power marketers.

There are clear signs that regulators are moving to provide the atmosphere conducive to greater competition. Following Congress' intent in the National Energy Policy Act of 1992, the Federal Energy Regulatory Commission (FERC) in April 1995 issued two consolidated Notices of Proposed Rulemaking. As proposed, the notices addressing wholesale electricity transmission are supportive of electric utility credit quality, although they may be modified before actual implementation. The notices deal with several areas of interest to bondholders. Most significant to bondholders is FERC's insistence that utilities recover stranded costs incurred because of wholesale customers leaving a utility's system to purchase power elsewhere. Stranded costs refer to utility investments in relatively expensive generating facilities, above market purchased power obligations, and various other costs incurred and investments made under the historical cost-plus regulatory regime.

While FERC may well modify the notices after receiving comments, the general approach seems clear. Now the action moves to the states, which regulate roughly 85%-90% of electric utility revenues, and that is much more important for bondholders.

At the state level, the regulatory transformation is no less monumental. However, ongoing efforts are fragmented given the near 50 jurisdictions. At the core, there is a shift from cost-based to market-based regulation.

Under the evolving regulatory framework, utilities are being deregulated and market forces are being substituted for regulation. Certain sectors may be deregulated completely over time.

The ultimate transformation in state regulation is the move to retail wheeling or direct access. Under this concept, some, or all, utility customers would be able to choose their supplier. In theory, a factory or residence in New Jersey, for example, would be able to buy power from Pennsylvania, for example, and pay a fee to the local New Jersey utility to transport the electricity.

The biggest obstacle to this happening is the transition costs—the investment that utilities

made under the old cost-plus regulatory framework with the expectation of recovery. In a competitive environment, the market may not be willing to pay as much. Most state regulators are keenly interested in the concept of retail wheeling, and a large number of states are studying the issues involved. The good news for bondholders is that they appear sympathetic to allowing utilities a reasonable opportunity to recover their past investments. In this regard, FERC's recent proposal will help set precedent.

Still, state regulators are under pressure to reduce rates soon so customers enjoy the fruits of competition now. Given that this conflicts with 100% recovery of transition costs, Standard & Poor's anticipates that regulators may end up adopting a "share the pain" approach. That is, most costs will be recovered from departing or remaining customers, but some will be absorbed by the utility's shareholders. To the degree utilities cannot cut their operating costs, profits will suffer. Moreover, even if regulators authorize recovery of stranded costs, customers may not be willing to pay them. The market will ultimately determine to what extent, and over what time frame, utilities will recover their past investments.

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Can the arrival of retail wheeling be predicted? Based on efforts under way, Standard & Poor's believes that widespread retail wheeling, or its marketplace equivalent, will be in place for the industrial market within two to four years, for the commercial market within three to six years, and for the residential market within four to seven years. Reasons for this estimate are not simple.

Since market pressures are building for greater competition in retail markets, certain segments of industrial retail markets are already very competitive. However, utilities will do what they can to put off the further advance of competition—delay is in their best interest. As time passes, utilities can recover their sunk costs through depreciation and can prepare for a competitive future by cutting operating costs. However, the force of economics driven by technology will in time overwhelm the current legal and regulatory obstacles to a competitive marketplace. This will be an evolutionary process.

The fundamental truth is that investors must be able to differentiate risks. There will be winners as well as losers. Proactive managements will aggressively cut costs; nimble utilities will gain market share at the expense of their more slothful brethren; credit-conscious managements will reduce debt and accelerate the depreciation of high cost assets; and creative managements will devise new revenue-producing services and businesses while staying mindful of the greater risks these may pose.

U.S. PUBLIC POWER

The credit outlook for the almost 200 municipally owned electric utilities rated by Standard & Poor's is generally stable. Most of these are retail systems that serve ultimate customers directly, and that will likely retain their credit strength due to the traditional benefits of public power, including:

- Lack of regulatory oversight. Public power systems are, for the most part, free of extensive third-party regulation. This freedom gives them the potential to be agile and responsive to industry changes.
- Resource advantages. Rated public power entities typically have newer plants, less nuclear risk, and smaller capital needs than their IOU counterparts.
- Secure customer base. Their high density and residential-dominant customer bases protect public power systems fairly well from immediate threats of loss of large loads.

Because of such advantages, rating upgrades far exceeded downgrades for the past five years. But, emerging competitive and financial pressures make it unlikely that this trend will continue. A number of recent visible downgrades foretells a trend of increasing credit pressure, particularly on the nation's larger public utilities.

For instance, the ratings on nine systems, which represent a significant $23 billion of total outstanding debt, have been downgraded since June 1995, when Standard & Poor's announced the business positions on 62 public power utilities. The outlook on all but one of these remains negative. The downgraded utilities are among the nation's largest publicly owned utilities, indicating stress on a greater dollar volume of utility debt than on the number of utilities which may be, or already have been, affected. Further, the outlooks on 20 municipal utilities are negative, while only two have near-term positive rating potential.

However, the strengths outlined above make it highly unlikely that there will be a large enough number of rating changes to move the average rating of public power systems from its current 'A'. Additionally, the diversity among these systems makes it difficult to generalize about the effects of competition on this segment of the industry.

Some municipals have several characteristic weaknesses that will make it difficult for them to compete in a free energy market. The majority of these systems are wholesale entities, which have been the first in the public sector to feel the heat of competition and the resultant negative implications on credit. In fact, seven of the 10 municipal electric systems downgraded by Standard & Poor's since June 1995 are wholesale systems. These weaknesses include:

- Excess capacity. Many systems have excess base-load capacity, the result of aggressive energy growth projections and construction during the late 1970s and early 1980s.
- Political and economic pressures. The political environment within which public power systems operate may not always be compatible with a more competitive utility industry. Though devoid of direct regulation and demand for dividend payouts, public power

systems face the political stress of demands for transfers to government general funds, for instance.

- Rate structure. Many municipal systems' rate-making flexibility is limited by these utilities' traditional preference for low residential rates, or by "cost-plus" rate methodologies, from incorporating more flexible, targeted "cost-of-service" procedures. A municipal system has the opportunity to be nimble and creative with its rates, as they are generally free of outside regulation. Many, however, face political obstacles from local boards or city councils, whose necessary approvals can prove daunting.
- Slow debt amortization. Public systems typically structure their debt to mature in level increments over 20-30 years. However, the reduced cash flow requirements of this type of structure gave public systems advantages relative to some IOUs that were also financing large-plant additions in the 1980s. However, many IOUs are exploring options to divest themselves of burdensome assets and, in some cases, accelerating their depreciation. This may put public power systems in a difficult position in a more competitive operating arena.

Like IOUs, public power systems have to deal with the realities of imminent competition. For many reasons they are in a better relative position to deal with competition's ramifications. However, many of these utilities will need to gain political support for their policies and initiatives.

Standard & Poor's does not expect that the public power sector will experience widespread nor immediate credit deterioration. While many systems, particularly wholesale entities, have weaknesses which could lead to credit deterioration, most of the country's retail electric systems are protected from the immediate effects of competition. Municipals' relatively small, residential customer bases and rate flexibility will help these systems keep their credit intact.

Standard & Poor's will continue to incorporate both qualitative and quantitative features in its analysis of electric utilities in the throes of competition. Industry revisions will require changes in the emphasis—not the content—of Standard & Poor's analysis. The business position assessments will be a tool for investors to recognize which utilities will be at risk and which will adjust to the new environment and retain their credit quality.

CANADIAN UTILITIES

Although substantially greater competition in electric power markets has not yet come north of the Canada-U.S. border, two main factors are driving structural changes at the large provincially owned electric utilities:

- Trends in U.S. power markets and regulation, and
- Competitive threats from large electricity consumers opting for self-generation.

Events at Ontario Hydro since 1993 have been most visible. Former chairman Maurice Strong, hired in late 1992 to shake up the large (34,000MW generating capacity, US$6.3 billion in sales) utility, wrought substantial change to reduce costs and arrest a 1990-1992 trend of rate increases well above the inflation rate. Mr. Strong sought to reduce the threat of further self-generation during a period of substantial excess capacity, prepare the utility for the possibility of increased direct competition in Ontario power markets within the next five years, and increase the ability of Ontario Hydro to sell surplus power at attractive rates in export markets.

Mr. Strong was also a proponent of privatization, and saw advantages to the sale of at least part of the power giant's generating capacity, and perhaps transmission as well. The recently elected Progressive Conservative government is amenable to the concept of privatization, unlike its predecessor New Democratic Party government. However, quick action under new chairman Bill Farlinger would be precluded by the logistics of the implementation of such a sale, such as settling the issue of ownership of Ontario Hydro between the province and its founding municipalities; the construction of an appropriate regulatory regime for what would likely be a transmission monopoly; and the thorny issue of how to treat Ontario Hydro's nuclear assets (which accounted for 64% of power generation in 1994). Ontario Hydro's 'AA-' rating and stable outlook continue to reflect the guarantee of the province of Ontario.

Another provincial electric utility, Newfoundland and Labrador Hydro (NLH), was considered a candidate for privatization in 1994 by the Newfoundland government. However, the government decided to focus instead on generating a return to the public purse from the utility by having the utility pay an annual dividend to the province. The dividend announced in the provincial budget in spring 1995 for the fiscal year April 1995 to March 1996 was slightly greater than earnings the utility generated in its calendar 1994 results. Clearly, changes to the utility's cost structure, or to revenues, or both, would be required to sustain similar dividends over time. Changes to the utility's regulation may be necessary if higher rates are required to generate a positive return on the province's equity in the utility.

British Columbia Hydro and Power Authority (BC Hydro) has indirectly felt the impact of increasingly abundant, cheap electric power south of the Canada-U.S. border. In a still unresolved dispute with the Bonneville Power Authority (BPA), BC Hydro stands to lose a substantial stream of payments from BPA, as per a memorandum of understanding signed in September 1994. The basis of the payments stems from the 1964 Columbia River Treaty, which gives BC Hydro the rights to half of the incremental power generated by BPA from water flowing from dams constructed in BC in the 1960s. According to the memorandum of understanding, BPA would

purchase BC Hydro's allotment of power at 1994 prices, beginning in 1996. Since the signing of the memorandum of understanding, BPA has determined it could minimize its costs and still fulfill its treaty obligation by building a transmission line to dump the power at the BC border, rather than purchasing BC Hydro's allotment at what since late 1994 has become an uneconomic price. If BPA proceeds with its plan, BC Hydro would face an even greater surplus of capacity than it now has in place. However, the 'AA+' rating of BC Hydro is unlikely to be unaffected, as it is based on the guarantee of its provincial owner.

The three major Albertan electric utilities, though not rated by Standard & Poor's (Edmonton Power is owned by and receives funding from the city of Edmonton, which is rated 'AA'), are undergoing a gradual shift to more open competition, beginning in 1996. Current generation and transmission costs will continue to be cost-averaged through a provincial pool, though new generation will not be cost-averaged. All power from both old and new generation projects will be sold to a revised provincial pool on a competitive basis, with all plants in the system guaranteed a minimum of allowed fixed cost coverage, to prevent existing assets from being stranded. The sharing of generation costs will be phased out as existing plants retire from service, according to schedules set for each existing plant. The retirement schedules, and determination of allowed fixed costs, will be set following hearings in the coming months.

For detailed Public Utilities Commentary and Rationales, please see Standard & Poor's Global Sector Review, November 1995.

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CAPITAL ADEQUACY MODEL FOR L/H INSURERS MODIFIED

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Standard & Poor's has updated its capital adequacy model for life/health insurers to reflect changes in the companies' investment and operating environments. These changes improve the model's utility as a tool for differentiating levels of capital strength between companies. Though Standard & Poor's view of some companies' capital adequacy may change as a result, the claims-paying ability ratings of most companies will not be affected. Also, the existing standards for interpreting the capital adequacy ratio have not changed.

The expectation of minimal rating changes is based in part on results of testing the new model's ratios based on year-end 1994 data of a representative sample of companies with claims-paying ability ratings. The model changes affect the charges for specific assets and liabilities and are based on Standard & Poor's experience in using the model as a significant part of the rating process over the past few years. The revised model also incorporates the availability of updated information, such as bond default studies.

There are a number of significant differences between Standard & Poor's model and the risk-based capital model of the National Association of Insurance Commissioners (NAIC). The two most prominent differences are that Standard & Poor's uses its model to differentiate levels of capital strength among adequately capitalized companies, and that the model is flexible enough to adapt to unique balance sheet features. The model effectively provides capital requirement benchmarks for a broad array of assets and liabilities, and thus enhances analysis of an insurer's financial strength while providing sufficient leeway for flexibility and the use of prudent analytical judgment when interpreting the results. Also, the model is responsive to the dynamic environment in which life/health insurers operate. Adjustments determined by the analyst provide the model with the flexibility to adapt to changes in the regulatory, tax, legal, accounting, and economic environments.

Standard & Poor's evaluation of capital adequacy is influenced by expectations as to how a particular company's level will develop over time. Thus, while the assessment of capital adequacy is based on the company's assumed risks at any given point, prospective capital adequacy is considered equally important.

While considerable attention is focused on risk-based capital ratios, the assessment of capital adequacy is only one of many elements used in arriving at a financial strength rating for a company. Standard & Poor's rating process will continue to be predicated on the belief that capital adequacy ratios are not a substitute for broad-based analysis of insurer credit quality. Strength or weakness in other key areas, such as a company's management and corporate strategy, business profile, operating performance, liquidity, and financial flexibility can more than offset relative strength or weakness in capital adequacy.

PRIMARY GOALS

Standard & Poor's has two primary goals in assessing the capital adequacy of a life/health insurer:

- To assess, in an absolute sense, the capital strength that an insurer has relative to its assumed risks.
- To assess capital strength relative to that of other life/health insurers.

Both these goals seek to incorporate an evaluation of capital adequacy that is prospective, rather than at a specific point in time.